

New Issue: [Hawaii \(State of\)](#)

MOODY'S ASSIGNS Aa2 RATING TO \$350 MILLION STATE OF HAWAII GENERAL OBLIGATION BONDS OF 2006, SERIES DI

Aa2 RATING AND STABLE OUTLOOK APPLY TO \$4.1 BILLION OUTSTANDING G.O. DEBT OF HAWAII

State
HI

Moody's Rating

ISSUE	RATING
General Obligation Bonds of 2006, Series DI	Aa2
Sale Amount	\$350,000,000
Expected Sale Date	03/08/06
Rating Description	General Obligation

Opinion

NEW YORK, Feb 23, 2006 -- Moody's Investors Service has assigned an Aa2 rating with a stable outlook to the State of Hawaii's general obligation bonds. The rating incorporates the state's historical fiscal conservatism; its sound financial position bolstered by strong revenue growth; a tourism-based economy with some diversification occurring in other employment sectors; and a high debt burden. Hawaii's economy exhibits positive trends, with employment gains in most sectors, a strong housing market, and healthy growth in tourism-related travel. Even with some draws on reserves, Hawaii maintained solid financial results through a recent period of strain on the state's tourism-based economy and Moody's expects that the state will continue to make the necessary budgetary adjustments to maintain fiscal stability.

The General Obligation Bonds of 2006, Series DI bonds will be used to finance or to reimburse the state for certain expenditures for public purposes for which appropriations have been made. These include the Hawaiian Home Lands Settlement (\$30 million) and various capital projects to improve elementary and secondary schools, public buildings and facilities, community colleges, universities, as well as public parks and libraries.

Credit strengths are:

*Healthy pace of tax revenue growth continues.

*Available balances provide financial flexibility in the event of unexpected revenue falloff.

*Positive economic trends with employment gains in all sectors, a strong housing market, and healthy growth in tourism-related travel.

*Well-established multi-year and quarterly consensus forecasting by state's Council on Revenues.

*Historical fiscal conservatism.

Credit challenges are:

*Debt ratios likely to remain very high given state level capital funding on behalf of local governments, especially for education.

*Vulnerability to sudden shifts in tourism-based economy, resulting in revenue fall-off and budget shortfalls.

*Large government employment sector contributes to spending pressure for salary and benefit settlements.

CONSERVATIVE BUDGET CONTROLS POSITION STATE WELL TO MANAGE ECONOMIC DOWNTURNS; STATE CONSTITUTION REQUIRES REVENUE FORECASTS

Pursuant to the state constitution, the state legislature is required to establish a General Fund expenditure ceiling that limits the annual rate of expenditure growth to the rate of growth of the economy. State appropriation levels from the General Fund may not exceed the expenditure ceiling without a two-thirds vote of both houses of the legislature. The expenditure ceiling is determined by adjusting the prior year expenditure ceiling by the estimated growth in the state economy. This growth factor is determined by averaging the annual percentage change in total state personal income for the prior three years. Appropriations for the last eight fiscal years did not exceed the expenditure ceiling, including the 2004-2005 biennium. This expenditure limitation, combined with conservative forecasting and periodic updating by the state's Council on Revenues, mitigates fiscal stress during the business cycle.

The State Constitution requires the Council on Revenues to prepare revenue estimates which serve as the basis for the governor's budget preparation and the legislature's appropriation of funds and enactment of revenue measures. The council reports its estimates and revisions each June 1, September 10, January 10, and March 15. The council also revises its estimates when it determines that such revisions are necessary or upon request of the governor or the legislature.

HEALTHY TAX REVENUE GROWTH LEADS TO UPWARD REVISION OF REVENUE FORECAST; OUTYEAR PROJECTIONS REFLECT MORE MODERATE REVENUE GROWTH

Hawaii has realized strong revenue gains in the past three years. Fiscal 2004 audited financial data shows a very strong 9.6% increase in General Fund tax revenue collections over prior year results, more than double the 4.1% growth in fiscal year 2003. Results for fiscal year 2005 were even stronger, with General Fund tax revenues increasing nearly 16%. The revenue forecast for fiscal years 2006 and 2007 was revised upward in December 2005. As a result, General Fund tax revenues for fiscal year 2006 are projected to grow by a healthy 8% and 7.5% for fiscal year 2007, up from earlier estimates of 6% and 6.6% respectively. Substantial gains in both general excise and income tax receipts are driving the revised forecast. These positive results reflect the steady improvement in visitor arrivals, reversing the negative impact of the September 11th attacks on Hawaiian tourism, the state's primary economic driver. General excise taxes, representing about half of General Fund revenues, jumped 13% in fiscal year 2005, nearly double the prior year's growth rate of 6.9%. The state's income tax, which makes up roughly one-third of General Fund revenues, grew 16.8%, on top of a 14.5% increase in fiscal year 2004. These strong operating results also reflect the continued strength of the construction industry, as both the commercial and residential construction markets remain strong in this low interest rate environment. Despite the strength of the recent revenue performance, Hawaii forecasts more moderate tax revenue growth of 7.1% in fiscal year 2008 and 5% in fiscal year 2009.

Hawaii recorded a second consecutive year of operating surplus in fiscal 2005 and continued to replenish and grow available General Fund balances that were tapped to address budgetary shortfalls in fiscal years 2002 and 2003. Fiscal year end 2005 results show a healthy General Fund unreserved, undesignated balance of approximately \$715 million, 17% of General Fund revenues which surpasses the previous peak of 15% recorded at fiscal year-end 2001.

Hawaii expects to record another operating surplus of \$574 million at the end of fiscal year 2006. The governor has proposed the one-time use of a portion of these funds to provide \$286 million tax relief. In addition, the governor's supplemental budget plan includes spending increases in education, affordable housing initiatives, and expanded access to medical care and social services. While these measures would result in a planned operating deficit in fiscal year 2007 and an increase in ongoing spending going forward, current projections indicate budget balance in fiscal year's 2008 and 2009 reflecting the state's healthy revenue performance. Farther out, Hawaii faces some Medicaid spending pressures, a rapidly growing challenge for most states. While settled for the current biennium, future collective bargaining agreements could also lead to increased baseline spending beginning in the next biennium, 2008-2009.

ECONOMY CONTINUES TO OUTPACE NATION; TOURISM INDUSTRY SHOWS CONTINUED GROWTH OVER PRIOR YEARS

Hawaii posted a 2.8% gain in total non-farm employment in 2005, the seventh consecutive year of positive job growth in the state as reported by the Bureau of Labor Statistics. The state's performance last year easily outpaced that of the nation which realized job gains of 1.5%. Hawaii's unemployment rate was under 3% in 2005, the lowest in the nation. Since 2001 Hawaii's unemployment rate has remained below the national level, reversing a pattern in the 1990s when the state's unemployment level rose while the national rate declined. The national economic performance continues to be tempered by job losses in manufacturing, a sector that represents less than 3% of total employment in Hawaii. It should be noted that unlike previous years, the state's primary source of jobs growth was not the government sector. Employment gains have been strong in several industry sectors, particularly services and construction. The construction sector remains strong due to the current low interest rate environment. The services sector growth reflects some diversity of the state's employment base beyond the tourism industry, with positive gains posted in educational and health services, and professional and business services.

Hawaii's tourism market remained strong in 2005 with visitor arrivals setting a new record of 7.4 million.

Combined visitor arrival trends for 2005 show a 6.8% increase over the prior year which saw a 10% growth. International visitor arrivals continued to improve in 2005 after returning to pre-2001 levels in 2004. International travel appears to have recovered from the 2004 travel dampening effects of SARS and the war in Iraq. Other indicators such as average hotel occupancy and daily hotel room rates also show positive trends. Overall, Hawaii's leisure and hospitality industry continues to post strong and steady job growth for the third consecutive year.

LARGE MILITARY PRESENCE PROVIDES STABLE EMPLOYMENT BASE

Federal defense spending in Hawaii, dictated by the island's strategic geographic importance, plays a large part in the state's economy. Total government employment in Hawaii is 21% of non-farm employment versus 16% nationwide. Federal activity in Hawaii amounts to about 13% of the state's gross state product, with much of it defense related. The large federal defense presence provides a continuing and stable source of employment and income which helps to support the state's volatile tourist-based economy. This is augmented by federal transfer payments for Social Security and federal retirement benefits which also support the state's economy. The state economy should benefit from military expansion plans over the next four to six years, including basing the Stryker Brigade Combat Team in Hawaii, and the privatization of military housing.

"RAINY DAY" FUND BALANCE FUNDED WITH TOBACCO SETTLEMENT PAYMENTS

As part of the \$206 billion Tobacco Settlement master agreement between the major tobacco companies and 46 states and 5 US territories, the state of Hawaii is expected to receive a total of \$1.5 billion. The annual payments to the state will range from \$42 million to \$63 million through fiscal year 2027. During the 1999 legislative session, the state legislature approved a bill stipulating how these settlement proceeds would be allocated. Pursuant to the provisions of the bill, 40% of the annual payments received will be deposited into a newly-created Emergency Budget and Reserve Fund (EBR). The law also stipulates that appropriations from the fund, which require a two-thirds majority vote of each house of the legislature, can only be made during times of emergency, economic downturn or unforeseen reductions in revenues.

The state has since revised this allocation method by reducing the percentage of the payment to be pledged to the EBR. Beginning in fiscal 2004, only 24.5% of the annual settlement payments is pledged to the fund. The EBR Fund balance as of June 30, 2005 was \$54 million, a relatively modest 1.3% of General Fund revenues. However the combined available balance, reflecting unreserved General Fund balance plus emergency reserves, amounted to \$769 million at fiscal year-end 2005, a strong 18% of revenues. The state expects the EBR balance to grow to \$64.7 million by the end of fiscal 2008. The governor's budget proposal includes the addition of \$55 million to the EBR from the fiscal year 2007 surplus to bring the level to \$119 million.

DEBT BURDEN REMAINS AMONG THE HIGHEST IN NATION

Hawaii has historically been one of the nation's most heavily-indebted states, both in terms of net tax-supported debt as a percentage of revenue, and debt per capita. Based on Moody's 2005 State Debt Medians Report only two states rank higher than Hawaii based on debt per capita, in part because the state provides capital funding for many functions performed at the local level in other states such as capital financing for schools. For debt as a percentage of personal income, Hawaii's 11.1% ratio is more than 4 times the 50-state median. This high debt burden places significant strain on the state's operating budget, as total general obligation bond debt service as a percentage of the budget exceeds 10%. Pension contributions are another area of expenditure concern given the recent decline in the state's retirement system funded ratio to 68.6% at fiscal year-end 2005 from 71.7% the prior year.

Outlook

The stable outlook for Hawaii's credit rating reflects the state's strong management of its finances given the volatility of its tourism-based economy. In addition, the state's strong economic performance, with its heavy dependence on tourism, appears to be sustainable for the near term. Recent indicators show some economic diversification, with increased employment in service sectors outside of leisure and hospitality, underscoring the state's resilience despite a slow US economic recovery. Military investment in the state should generate economic growth over the next several years, and its presence in Hawaii should benefit from the nation's heightened state of alert. Hawaii's financial position is expected to remain sound, buoyed by the recent strong revenue growth, with reduced likelihood that the state will need to draw down fund balances to meet its spending commitments, while maintaining positive audited financial results.

What would it take for rating to move up?

*Maintenance of strong reserve levels.

*Broader economic diversification, sustained job growth, and reduced vulnerability to the tourism industry.

*Maintenance of structural budget balance.

What would it take for rating to move down?

*Economic weakening leading to employment erosion.

*Slowing of revenue trends leading to budget imbalance, liquidity pressure, and narrowing of financial position.

*Use of non-recurring solutions to balance budget.

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